Introduction: Borrowing to Live

NICOLAS P. RETSINAS AND ERIC S. BELSKY

Not so long ago, when poor people desperately needed a loan, they sought out neighborhood sharks—and paid and paid. Or they relied on retailers like car dealers and furniture stores to finance their purchases. Houses were beyond reach. Before the Community Reinvestment Act in 1977 was enacted, deposit-taking banks—the traditional mortgage lenders—often rejected them. These banks would offer thirty-year fixed rate mortgages, generally with 20 percent down payments, to middle- and upper-income Americans. But these borrowers' credit met the lenders' standards: in the jargon, they were "prime" borrowers. The would-be homeowners without stellar credit were "subprime," and mainstream lenders spurned them.

Over the past thirty years, America's entrepreneurial credit industry recognized an opportunity. Subprime borrowers might entail greater risk, but you could compensate for that risk with higher fees and higher interest rates. And people eager to buy homes would pay those fees and interest rates. A new niche industry quickly evolved: subprime lenders. New mortgage banks sprang up. Millions of renters bought homes. Subprime lending soared from nearly none in the early 1990s to 20.1 percent of all originations in 2006.

Poor people were no longer borrowers non grata. Indeed, low-income consumers have been able to borrow easily—critics would say too easily. Lenders were willing, even eager—again, in hindsight, critics would say too eager—to extend credit via a dizzying assortment of products, including no down payment, variable payment, and negative amortization. Credit card companies joined in the frenzy. Just about anybody could get a credit card. If a guardian angel had awakened George Bailey to America in 2000, the kindly banker would have cheered this new world of credit that let many Americans own their homes and buy whatever their hearts desire.

For at least fifteen years, the world of looser credit made many people happy. Low-income renters owned their homes (which some used as ATM machines, spurring a surging market in home equity loans); mortgage brokers received their commissions (paid whether or not the homeowner defaulted); and investors who bought the securitized mortgages earned double-digit returns. And predatory lenders, who profited when borrowers defaulted, crafted a lucrative and nefarious microniche in this niche market.

If George Bailey had awakened to the world of American credit in 2008, he would have been alarmed.

We have learned that too-good-to-be-true deals generally are flawed. They are not good for consumers and are equally toxic for the communities and the nation's financial system. Many homeowners who faced a bump in interest rates could not pay the higher monthly payments because they were allowed to buy homes that stretched their incomes perilously thin, even at the outset. Speculators could easily get credit and then were all too willing to default on their loans when the opportunity to profit from rapid appreciation passed. And a slackening market, with falling home prices, left homeowners and speculators alike unable to recoup their investments or refinance their mortgages when things soured. Homeowners discovered that they owed more than their homes were worth, and many were surprised by the terms of their mortgages, which were often hard to understand. As for the mortgage investors who bought the securitized bundles of subprime mortgages, they watched their net worth drop.

In 2006, when Harvard University's Joint Center for Housing Studies began planning a Symposium on Understanding Consumer Credit, we were, in hindsight, at the apex of housing prosperity, thanks in large measure to a robust subprime industry. We reached out to the Ford Foundation, Freddie Mac, and NeighborWorks® America to help us solicit, organize, and present research on all facets of consumer credit linked to the financing of a home. The symposium was conducted in November 2007 at the Harvard Business School. Two previous symposia with the same sponsors led to two books entitled *Low-Income Homeownership: Examining the Unexamined Goal* (2002) and *Building Assets, Building Credit: Creating Wealth in Low-Income Communities* (2005).

The Center invited researchers to play the role of iconoclasts and statistically probe the effect of consumer credit on borrowers, communities, and our nation. A group of lenders, advocates, and regulators dissected the findings. This book highlights the key papers from that effort.

For America in 2008, credit undergirds everyday life. In our economy most low- and moderate-income people borrow to live on their income. They are not borrowing to keep up with the Joneses; they are borrowing to stay afloat, to keep up with payments for housing, food, transportation, and health care. How they negotiate that credit—whom they borrow from, the terms, the collateral, the conditions—defines our well-being as a nation.

In chapter 1 Belsky, Essene, and Retsinas ("Consumer and Mortgage Credit at the Crossroads") begin the dialogue by tracing the surge in aggregate debt-to-income and debt-service ratios. Today consumers carry more debt than ever and spend more of their income servicing that debt. Borrowers confront a panoply of products, but just as the credit choices have grown more complicated, so too has the potential for wildly unrealistic risk. The paper lays out straightforward ways to assist consumers: counseling, more flexible payment schedules, and insurance products that can mitigate the risks of job loss, disease, and disability.

Cole, Thompson, and Tufano in chapter 2 ("Where Does It Go? Spending by the Financially Constrained") use data from H&R Block to analyze the spending decisions of more than 1.5 million Americans. Not surprisingly, they find that would-be borrowers who cannot borrow from subprime lenders are more likely to spend any tax refunds more quickly and are more likely to spend for necessities.

Sawady and Tescher in chapter 3 ("Financial Decisionmaking Processes of Low-Income Individuals") highlight the emotional context of borrowing. Rationally, based on price and convenience, a given borrower with a set income "should" turn to a traditional bank or credit union, not a subprime lender, and certainly not the local pawnbroker. Yet economics and convenience do not determine all borrowing decisions. Consumers who live in neighborhoods where everybody goes to one subprime lender may follow suit. Indeed, immigrants who distrusted banks in their native lands often distrust banks in this country.

McCoy and Renuart in chapter 4 ("The Legal Infrastructure of Subprime and Nontraditional Home Mortgages") review the pastiche of regulatory paradigms. Banks have gravitated to the more flexible national bank charters, in part to flee state regulation, and the lax regulation of nonbank mortgage lending subsidiaries, coupled with the conflicting mandates of federal banking regulators, has left few private remedies for borrowers.

Bostic, Engel, McCoy, Pennington-Cross, and Wachter in chapter 5 ("The Impact of State Antipredatory Laws: Policy Implications and Insights") discuss the patchwork of antipredatory laws across states. Roughly half the states have passed laws that range from weak to rigorous. Rigorous laws can be designed to restrict predatory loans while preserving, even increasing, the vitality of the subprime market. Weak laws, though, give consumers false confidence that government is protecting them from a predatory loan.

In chapter 6 Barr, Mullainathan, and Shafir ("Behaviorally Informed Home Mortgage Credit Regulation") plumb the role of psychology in consumers' choices. One option, a fixed-rate thirty-year mortgage, with a 20 percent down payment, may be the "best" from an economic vantage. Yet a qualified borrower chooses a variable-rate or a no-down-payment or a negative amortized product. Why? The sheer choice among highly touted, much-advertised products can influence the decision: much as you pick the most-touted, best-placed cereal on the shelves, you may pick the most-touted loan. The authors explore governmental reforms such as better disclosure requirements, mandatory rate-sheet pricing, and bans on yield spread premiums.

In chapter 7 Cutts and Merrill ("Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs") analyze the true costs of foreclosures. The timeline for foreclosures ranges from 60 days to 120 days, depending on the state. Although housing advocates have argued for longer timelines to give owners more opportunity to forestall the sale, the authors point to the effect of longer delinquencies: more time for the property to deteriorate and lose value, with the concomitant effect on abutting houses. The authors conclude that states could reduce investor costs and reduce foreclosure rates by shortening the statutory timelines.

Finally in chapter 8, Kempson ("Looking beyond Our Shores: Consumer Protection Regulation Lessons from the United Kingdom") comments on self-regulation in the United Kingdom, where banks voluntarily embrace codes of conduct for lending. The sanction for breaking that code is public disclosure, or "name and shame." The author notes the weak oversight of unsecured lending.

This volume offers a window into the new world of consumer credit. The authors reach provocative conclusions, reflecting the desire to balance two goals: protect the consumer and at the same time expand consumer choice. Policymakers who wrestle with the acknowledged limitations of government oversight in this changing marketplace should find the papers useful.

The symposium has stimulated further dialogue. This volume does not provide definitive answers—nobody has discovered a magic-wand solution. But the research points us in the right direction.